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POSTAL RATE AND FEE CHANGES, 1997)

DOCKET NO. R97-1

OFFICE OF THE CONSUMER ADVOCATE

INITIAL BRIEF

FIRST SECTION

RESPECTFULLY SUBMITTED,

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MARCH 16, 1998

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APPENDIX

I. INTRODUCTION

Pursuant to P.O. Ruling R97-1/55, setting forth the revised procedural schedule in this case, the Office of the Consumer Advocate ("OCA") hereby submits the first section of its initial brief. Initial briefs are due in this case on or before April 1, 1998. OCA is filing the first section of its brief to give parties more time to consider the arguments made herein.¹

¹ We do urge the Commission to consider and address all Postal Service and intervenor classification and methodological proposals. OCA addresses the merits of a number of such proposals in the sections of the brief to be filed later.

II. THE POSTAL REORGANIZATION ACT REQUIRES THE
COMMISSION TO REJECT THE REQUESTED
POSTAL SERVICE RATE LEVEL INCREASE BECAUSE
THE POSTAL SERVICE HAS NOT MET ITS
BURDEN OF PROOF THAT IT WILL HAVE A DEFICIT
DURING THE TEST YEAR.

A. The Statute Provides For Rates To Be Set At Break-Even.

The Postal Reorganization Act,² provides that the Commission shall make a recommended decision on a Postal Service request for changes in rates or fees in each class of mail or type of service in accordance with the policies of this title and [nine enumerated] factors. Two fundamental policies of the Act are set forth in § 3621 of the Act. One policy is that postal rates and fees shall be reasonable and equitable and sufficient for the postal service needs of the United States. The other of the two fundamental policies provides:

Postal rates and fees shall provide sufficient revenues so that the total estimated income and appropriations to the Postal Service will equal as nearly as practicable total estimated costs of the Postal Service.

In other words, the rates are to be established so that the Postal Service operates on a break-even basis. The rate level must be established so that revenues will be as near as practicable to the expenses.

It is OCA's position that the record in this case, together with other evidence of which the Commission may take official notice, demonstrates that the Postal Service in all probability will earn a significant profit during the test year. In these circumstances, the break-even policies of Title 39 not only strongly suggest but in fact require that the

² 39 U.S.C. § 3622(b).

Commission shall make a recommended decision that there must be no overall change in the rate level in this proceeding.³

B. Commission Regulations And The Test Year.

The test year procedure involves determining the estimated or actual allowable costs during the test year and setting rates based on the costs incurred during the test year--not another period.

Commission regulations establish the parameters for the test year. The Commission regulations provide only a few limitations.⁴ Most significantly, the test year must be reasonably close to the initial filing date. The test year is selected by the Postal Service in the first instance. In this proceeding the 1998 test year commenced less than three months after the filing date on July 10, 1997. The Postal Service has not requested any modification of the test year.

³ The Commission is nevertheless free within this standard to make adjustments within the current rate level to each class of mail or type of service as it finds necessary in accordance with other policies of Title 39.

The Postal Service originally estimated a large loss for the test year and because the increasingly favorable financial picture for the Postal Service has evolved over the period of this case, OCA did not attempt to establish a record which considers the statutory requirements when a substantial profit will be earned during the test year. However, there is nothing in the language of the statute to preclude the Commission from recommending rates and fees at a level *lower* than the rates in effect during the proceeding. Indeed, for the break-even policy to be applied "as nearly as practicable," the Commission is probably under an obligation to recommend a lowering of rates where the Postal Service has requested the Commission to submit a recommended decision on proposed changes in a rate or rates of postage or fees.

⁴ § 3001.54(f),(j). The requirements were discussed in greater detail in the Office of the Consumer Advocate Response to Notice of Inquiry No. 5 on Recognizing Interim Year Results, February 13, 1998 at 3-4.

The rate level is guided by estimated revenues and expenses during the test year. No adjustment is made for future anticipated increases in revenues or expenses that will occur after the close of the test year. On the other hand, adjustments may be made to the test year estimates for actual financial results becoming available during the proceeding.⁵

C. The Postal Service Request.

The Postal Service filed its request for relief on July 10, 1997. The filing projected a revenue shortfall (net loss) for the test year of \$1,387.3 million.⁶ Subsequent revision has adjusted that amount to \$1,391.9 million.⁷ This is based upon the audited base year data for FY 96 rolled forward for two years with estimates for volumes, revenues and expenses. Since the filing, however, actual numbers for the interim year have dwarfed the profits estimated in the initial filing. The Postal Service filing projected an estimated 1997 net income of \$0.636 billion,⁸ but the Postal Service earned a net income of \$1.264 billion, almost twice as much as projected⁹ or \$0.628 billion more income than projected.

The 1998 test year estimates are based on a roll-forward of the 1997 interim year cost and revenue estimates. Consequently, recognition of the improved profitability figures for FY 97 requires the use of actual cost and revenue amounts for that year. Out

⁵ See PRC Op. R94-1, paras. 2026-7, PRC Op. R90-1, paras. 2007-12, PRC Op. R87-1, para. 2141, PRC Op. R84-1, paras. 1188-90.

⁶ Exhibit USPS 9A, as filed.

⁷ Exhibit USPS 9A, as revised.

⁸ Id.

⁹ See Postal Service 1997 Annual Report at 45.

of concern that the record does not include up-to-date information resulting in an outcome in this case "that does not sufficiently reflect actual events," the Commission requested that the Postal Service provide updated actual figures, but the Postal Service declined.¹⁰

As this case progressed, each accounting period has exhibited higher unanticipated profits--first for FY 97 and now for FY 98. Listed below is a summary of the Postal Service underestimations of FY 97 and FY 98 profits. The first underestimation was filed on July 10, 1997, after the close of three quarters of the 1997 interim year. These estimates have not been changed in the record by the Postal Service. The Postal Service also has continuously adhered to its original estimates in interrogatory responses, and the Postal Service declines to update its record estimates for 1998. The underestimations in the exhibits continue to this day without interruption.¹¹ In this record, the Postal Service projects a test year operating loss of \$1.391 billion while its Chief Financial Officer has reported lesser estimated losses to the Board of Governors.

In 1997, as late as the end of accounting period 11 (at which time the Postal Service had recorded a year-to-date net income of \$1,292.4 million), the Postal Service expected losses for the last three accounting periods totaling \$519 million.¹² The Postal Service ended the year with a profit of \$1,264 million, only \$28 million less than what it had recognized on a year-to-date basis at the close of accounting period 11.

¹⁰ Letter to the Chairman of the Board of Governors, February 24, 1997. See response to Chairman Gleiman dated March 3, 1998, from the Chairman of the Board of Governors, Sam Winters.

¹¹ Tr. 9/4398-99, See rebuttal testimony of witness Porras, *USPS-RT-11*.

¹² Tr. 9/4398 (\$202.4 million + \$254.2 million + \$62 million).

Significantly, this raises questions about the Postal Service's ability to accurately project its net income, even for three accounting periods much less one or two years forward. This is not a minor inaccuracy, even though on a percentage basis the differential appears small. The underestimation was over \$500 million for a period of less than three months.

In this proceeding the Postal Service is estimating a net revenue deficiency including amounts for contingency and RPYL in test year 1998 of \$2.447 billion and is seeking commensurate increases in its rate levels.¹³

D. The Burden Of Proof Is On The Postal Service To Demonstrate The Estimated Revenues In The Test Year Do Not Equal The Estimated Costs.

In ratemaking proceedings of the type exemplified by this docket, the Postal Service, seeking adjustments to the rate structure, is the proponent of change.¹⁴ The Administrative Procedure Act states that "[e]xcept as statutes otherwise provide, the proponent of a rule or order shall have the burden of proof."¹⁵ "Burden of proof" in this context refers to the burden of going forward with the evidence.¹⁶ The general rule is that "the party who has the burden of pleading a fact will have the burdens of producing

¹³ Exhibit USPS-9A.

¹⁴ 39 U.S.C. § 3622(a).

¹⁵ 5 U.S.C. § 556(d).

¹⁶ Edles and Nelson, *Federal Regulatory Process: Agency Practices and Procedures* (1994), at 151-52. The burden of going forward is to be distinguished from the burden of persuasion (e.g., by a preponderance of the evidence). *Id.* at 152. See also Stein, Mitchell and Mezines, *Administrative Law*, § 24.02 (1996).

evidence and of persuading the jury of its existence as well.”¹⁷ The McCormick treatise on evidence notes that the “burdens of pleading and proof with regard to most facts have been and should be assigned to the plaintiff who generally seeks to change the present state of affairs”¹⁸

E. The Postal Service Has Not Met Its Burden Of Proof Because The Record Demonstrates The Postal Service Will Have A Profitable Test Year.

1. FY 98 actuals are available through accounting period 5 and indicate a net profit for the test year.

Since the filing of this case, the Postal Service has enjoyed favorable financial fortunes. Its net income for the interim FY 97 year was significantly underestimated. The FY 98 test year, which commenced in September 1997, within three months of the initial filing in this case, also has proven to be more profitable than originally estimated in the filing. The record reflects this recent actual financial history. Any fair reading of the record, even at this time, requires the conclusion that the Postal Service will not incur any loss during the test year, and most likely will incur a significant profit.

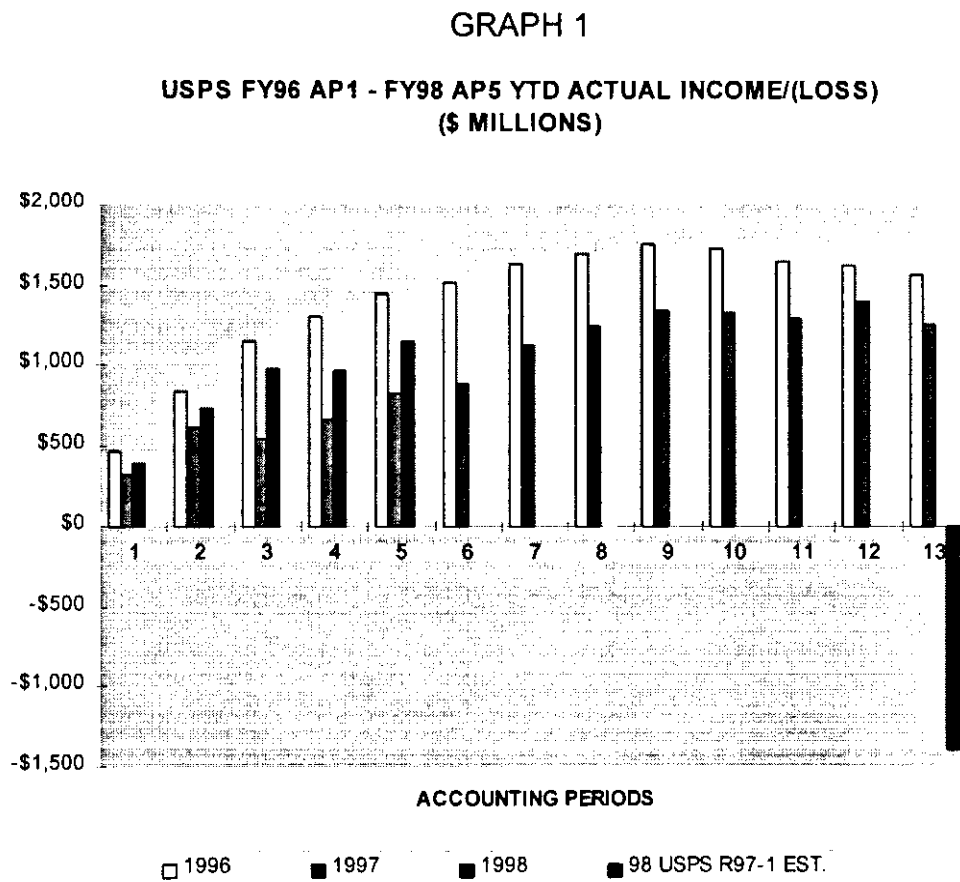
The following graph exhibits the actual reported earnings of the Postal Service through FY 98, accounting period 5, together with its budgeted estimate of net operating loss for the test year.¹⁹ The estimated net loss is the amount the Postal Service would

¹⁷ McCormick on Evidence (4th ed. 1992), at 427 (citations omitted).

¹⁸ Id. at 428.

¹⁹ Postal Service Financial and Operating Statements FY 96, A/P-1-FY 98, A/P 5, USPS 1997 Annual Report and exhibit USPS 9A. Tr. 9/4399, ANM/USPS-T-9-1g). See Appendix A for the data.

have the Commission use for purposes of setting future rates and fees. The difference between the actual year-to-date FY 98 earnings and the Postal Service's total FY 98 test year estimate is startling.²⁰



One wonders, and the record is silent, as to how the Postal Service expects its earnings to deteriorate so quickly from a year-to-date net income of \$1.1553 billion through A/P 5 to a loss of well over \$1 billion for the test year.

²⁰ Exhibit USPS 9A. Accounting period 5 ended Friday, January 30, 1998. Accounting period 6 is now complete and accounting period 7 will be complete on March 27. The earnings for these periods will be available to the Commission before its decision and order in this case is issued. OCA moves that the Commission take official notice of the earnings and budget amounts reported for A/P 6 and A/P 7 in the Postal Service Financial and Operating Statements which are due to be filed before the Commission's decision is issued.

In October, 1997, well before the favorable earnings for 1998 were recorded, the Presiding Officer appeared skeptical that the Postal Service profits would drop as precipitously as projected. Recent Postal Service earnings history has been, in round numbers, an annual decline in profits of about \$300 million per year (FY 1995-\$1.8 billion profit, FY 1996-\$1.5 billion profit, FY 1997 \$1.2 billion profit).²¹ For FY 98 the Postal Service has projected a sudden \$1.4 billion loss. The prediction is a year-to-year turnaround of \$2.6 billion (\$1.2 billion plus \$1.4 billion). Actual 1997 earnings and early FY 98 earnings strongly suggest the Presiding Officer's skepticism was not misplaced. The words of Supreme Court Justice Cardozo written many years ago suggest that the financial history of the last two years as shown on the above graph is a better picture of the future than the most rigorous of estimates. Judge Cardozo said:

The earnings of later years were exhibited in the record and told their own tale as to the possibilities of profit. To shut one's eyes to them altogether, to exclude them from the reckoning, is as much arbitrary action as to build a schedule upon guesswork with evidence available. There are times, to be sure, when resort to prophecy becomes inevitable in default of methods more precise. At such times, "an honest and intelligent forecast of probable future values made upon a view of all the relevant circumstances" [citations omitted] is the only organon at hand, and hence the only one to be employed in order to make the hearing fair. But prophecy, however honest, is generally a poor substitute for experience. [citation omitted]...A forecast gives us one rate. A survey gives another. To prefer the forecast to the survey is an arbitrary judgement.²²

The Postal Service is suffering from an embarrassment of riches. To grant it a rate increase at a time when it made money last year and will probably have excess revenue

²¹ Tr. 9/4572-76.

²² *West Ohio Gas Co. v. Comm'n*, 294 U.S. 79, 81-82 (1935).

in the current year and also in FY 99, if trends continue, would be contrary to the break-even policy of Title 39, § 3621 and the Commission's regulations.²³

The Postal Service would have the Commission rely upon its estimates made before the proceedings began. However, the D.C. Court of Appeals has made clear that estimates are merely the starting point in meeting the burden of demonstrating the reasonableness of requested rate increases.²⁴ It has approved another regulatory agency's analysis of the issue:

Once the utility has demonstrated the reasonableness of its estimates, the challenging party has the burden of showing that "subsequent events indicate that to use [the estimate] as a basis for future projections would yield unreasonable results." *Indiana Municipal Electric Association*, supra, at 485, quoting *Southern California Edison Company*, FERC Opinion No. 55, at 6 (August 1, 1979).²⁵

The Postal Service estimates may have been reasonable when made but the actual numbers indicate a significant profit will be earned in the test year and, therefore, the \$2.4 billion rate increase requested would yield unreasonable results in the form of unnecessarily excessive profits.

²³ This does not suggest that the Commission could not recommend certain modifications to the rates and services or approve methodologies for calculating the rates. Certain modifications without immediate rate increase consequences will be discussed in other parts of OCA's brief.

²⁴ 39 U.S.C. § 3621. "Postal rates and fees shall be reasonable...."

²⁵ *Indiana and Michigan Municipal Distributors Association v. FERC*, 659 F.2d 1193, 1198 (CA DC 1981). See also, *Villages of Chatham and Riverton v. FERC*, 662 F.2d 23, 29-30 (D.C. Cir. 1981).

This Commission has also recognized the validity of the court's line of reasoning in Docket No. R90-1.²⁶ There the Commission recognized that automatically substituting actual data for estimates is not the law, even where test year data is available at the time of the hearings²⁷ if it is shown the data will not improve the results; for instance, where the data are not typical, actual data would not be used.²⁸ The Commission further stated,

While, as the Seventh Circuit noted [in *Indiana Municipal*] there is also an obligation to show that the test year is itself representative...It is obvious that the potential gain in ultimate representativeness is far less in the [situation of updating the interim year].²⁹

In this case the Postal Service has not shown that test year actuals will not improve the results or that they are entirely atypical. Moreover, the Commission recognized the importance of using actual numbers which are representative of the test year.

The mere existence of a disparity between the estimate and the actual results is not enough to warrant the use of actual test year results as a basis for decision. Events subsequent to the original estimates must indicate that the use of the future projections would yield unreasonable results. A review of the graphs herein indicates just how unreasonable the resulting profits generated by the proposed rates would be.

²⁶ Opinion and Recommended Decision Upon Further Consideration, Docket No. R90-1, October 4, 1991.

²⁷ Id. at 24.

²⁸ Id. at 25.

²⁹ Id. at 26-27.

The Postal Service contends that, notwithstanding its recent unanticipated earnings, its proposed rate increase is necessary to avoid undermining the financial and policy goals of postal management.³⁰ However, the Postal Service has not demonstrated this. Despite its claims of a shortfall in FY 98, the Postal Service has not offered any evidence that programs of the Postal Service are being adversely affected by the test year financial position. The Postal Service is planning to spend about \$5 billion on "other programs" without any apparent financial strain in FY 98.³¹ Based upon its recent experience in FY 97 there is a greater likelihood that it cannot spend all the money it has said it plans to spend than there is of running out of funds.³² Nor is there any explicit evidence showing how its investment programs in the following year would be hindered if the rates are not increased. Since the filing, the Postal Service has begun benefiting from other financial success. As a result of the FY 97 earnings, the RPYL were significantly reduced by \$1.264 billion. Interest expense has also been reduced due to the reduction of outstanding debt resulting from the profits in FY 97 and the effects of refinancing at lower interest rates.³³

The Postal Service argues actual performance must be considered in the context of the entire filing. OCA respectfully suggests that approach is backwards. Instead, the entire filing must be considered in light of actual performance. Where the actual

³⁰ Rebuttal testimony of witness Porras, USPS-RT-11 at 4-7.

³¹ Tr. 9/4563.

³² Tr. 9/4561-65.

³³ Rebuttal testimony of witness Porras, USPS-RT-11 at 13-14, Exhibit USPS-RT-11C. See *also* Tr. 4517-19 (OCA/USPS-T9-39).

performance demonstrates significant earnings during the test year, a filing proposing significant rate increases must be scrutinized to insure the results are not unreasonable. The Commission is establishing rates based on the test year-- not on the basis of possible future needs after the test year.

The Postal Service also contends that reducing the revenue requirement would undermine program initiatives, and affect the size and frequency of rate increases and the restoration of equity.³⁴ During the test year there is no evidence that the present rates impact program initiatives. Neither witness Tayman nor witness Porras cite any specific problems. Obviously, the need for a post test year rate increase would be delayed by a present rate increase. However, post test year rate increases are not at issue in this docket. The Postal Service logic would de facto eliminate the break-even standard of review required by statute and virtually remove the Commission from its statutory duty to recommend rates. Finally, the Postal Service's preferences on the restoration of equity might be undermined but, unfortunately for the Postal Service, the policy on the restoration of equity has been established by the Commission as one-ninth of the remaining prior year losses. The Postal Service is far ahead of the nine year recovery amount set forth in Docket No. R94-1.³⁵ The facts demonstrate the Postal Service will earn profits in the test year and those profits go directly to reducing the prior year losses. To the extent the profits exceed the currently calculated one-ninth of the prior year losses (\$377.1 annually),³⁶ the Postal Service will actually recover a greater

³⁴ Witness Porras rebuttal at 5-6.

³⁵ The RPYL is discussed more fully later in this brief.

³⁶ Exhibit USPS-RT-11C.

amount of prior year losses than anticipated by Commission policy established in the last rate case.

Moreover, there are no offsetting considerations that suggest the 1998 earnings are atypical. The UPS strike in 1997 did not create enough of an impact to justify the entire variance from the initial estimates.³⁷ Nor is there any showing that the “unanticipated” Postal Service profits are short term. If anything, the trends suggest that profits will continue for several years. Profits have been declining at the rate of about \$300 million per year from \$1.8 billion for two years, but in FY 98 profits are well ahead of last year.³⁸ Even if an allowance is made for a contingency amount or for the RPYL, the need for a rate level increase does not appear likely to occur until at least FY 2000.

More specifically, the Postal Service reported a net income of \$996 million for the first three accounting periods of its test year. This is \$427 million greater than for the same period in 1997.³⁹ Without a 1998 rate increase, a simple extension based on the year-to-date performance as of A/P 1-4, and assuming equivalent 1997 earnings for 1998 for accounting periods 5 through 13, less the estimated UPS strike earnings impact, yields a projected net income for 1998 of \$1,402 million.⁴⁰ Since profits for A/P 5

³⁷ The UPS strike contributed about \$150 million to the FY 97 bottom line. Tr. 9/4547-48, Tr. 9/4573.

³⁸ Tr. 9/4572-72.

³⁹ First quarter 1998 less first quarter 1997 of \$549.4. Financial and Operating Statements, A/P 03 1997, November 9-December 6, 1996.

⁴⁰ See Office of the Consumer Advocate Response to Notice of Inquiry No. 5 On Recognizing Interim Year Results, February 13, 1998 at 12.

exceeded estimates as well as same period last year (SPLY), this projection is now even greater.

The profit projection should be contrasted to the Postal Service's present claim that without a rate increase the Postal Service will have a deficit of \$1,391 million. The Postal Service further contends on the record that even if the proposed rates had been implemented at the beginning of the test year, there would be a TYAR surplus of only \$35.6 million.⁴¹ This is clearly contrary to the direction of the Postal Service earnings reports.

There is no doubt that with financial miscalculations of this magnitude something significant is happening with Postal Service operations. Technological advances may finally be paying off. Improved management or the advantages of increased mail volume may not have been taken into account in the estimates. Significantly, for whatever reason, there are big positive changes taking place, and the causes are unknown. They have resulted in unexpected discrepancies between the usual estimating processes applied and accepted in past cases and actual results for each accounting period since the filing of the case.

There is no credible reason to believe the earnings trend will not continue. For instance, the first quarter 1998 net income announced at the February Board of Governors meeting included astonishing profits of \$976 million or almost twice the \$427 million profit from the same period last year. And this is in comparison to total earnings for FY 97 of \$1.26 billion.

⁴¹ USPS-T-9 at 47 (revised 8/22/97). This assumes the test year rates become effective at the beginning of the test year. Tr. 9/4571. See also, Tolley USPS-T-6 at 4.

2. The Postal Service budget estimates profits much larger than estimated in the rate case filing.

Besides the estimates made for the rate proceeding, the Postal Service has budget numbers which bear no relationship to the rate filing. For instance, in the rate filing the Postal Service indicated an estimated profit of \$636 million in the interim FY 97 year while its budgeted numbers being reported to the Commission in its Financial and Operating Statements for each accounting period were less optimistic.⁴² Those reports indicate a budgeted net profit for 1997 of \$177.4 million.⁴³ The basis for this apparent anomaly is unexplained by the Postal Service. Moreover, the Postal Service has declined the Commission's invitation for a cooperative effort to update the record with actual FY 97 figures to avoid the use of stale data. The Commission therefore is faced with the problem of outdated data that significantly differs from the original estimates and which, if used as a basis for determining the rate level, would clearly lead to unreasonable results.

Reliance on stale data may in turn endanger the validity of the Commission's decision. In OCA's response to NOI No.5 at 15, we noted that stale base-period data was one basis for court remand in *State of N.C. v. FERC*, 584 F.2d 1007, 1012, 1015 (D.C. Cir.). Other court decisions in this vein include *Sierra Club v. U.S. Nuclear Regulatory Commission*, 862 F.2d 222, 229, 231 (9th Cir. 1988) (on remand, Licensing Board should consider arguments that NRC's supplemental environmental assessment

⁴² See Postal Service Financial and Operating Statements filed each accounting period with the Commission.

⁴³ \$1,245.5 million less \$1,128.2 million, Financial and Operating Statements, A/P 13, PFY 97.

was based on stale data); *Freeport Minerals Co. v. U.S.*, 776 F.2d 1029, 1034 (Fed. Cir. 1985) (agency abused discretion in refusing domestic party's request for data collection for period extending up to date of agency's tentative determination to revoke antidumping order); *National Renderers Ass'n v. E.P.A.*, 541 F.2d 1281, 1289 (8th Cir. 1976) (matter returned to EPA for a thorough analysis based on complete, accurate and current representative data); *CPC International Inc. v. Train*, 515 F.2d 1032, 1051 (8th Cir. 1975) (EPA directed on remand to use more current data); and, *The Timken Co. v. U.S.*, 630 F. Supp. 1327, 1330 (C.I.T. 1986) (remand for collection and review of data up to the date of the tentative determination).

Thus, OCA concludes there is danger that this entire proceeding will be in peril upon appeal if the Commission fails to take into account the large actual FY 98 earnings reported to the Commission. The Commission must reject the Postal Service rate request altogether for failure to meet its burden of demonstrating that the current rate level is insufficient to meet test year expenses.

For FY 98, the Postal Service operating plan projects a loss of \$228 million.⁴⁴ Even though this "is not comparable to the Docket R97-1 rate filing because of timing differences" and is "hypothetical in nature, assuming that new rates were implemented on October 1, 1997,"⁴⁵ it is dramatically different from the filing and implicitly assumes much more favorable financial results. In fact, if anything, the losses under the operating plan should be greater than under the rate filing because the operating plan assumes the *old* rates are collected for nine more months. Surely the assumed implementation of the

⁴⁴ OCA/USPS-120.

⁴⁵ *Ibid.*

new rates on October 1, 1997 is not the cause of the greater operating losses under the rate filing. Nevertheless, Postal Service witness Porras claims "the revenue requirement underlying the current filing remains reasonable and does not require any adjustment."⁴⁶

Furthermore, analysis of the Postal Service operating plan indicates that even its comparatively rosy projections have been overly pessimistic so far in FY 98, underestimating profits year to date by \$136 million. However, the operating plan also projects for the rest of the year very large losses that would ultimately lead to the \$228 million loss mentioned above.

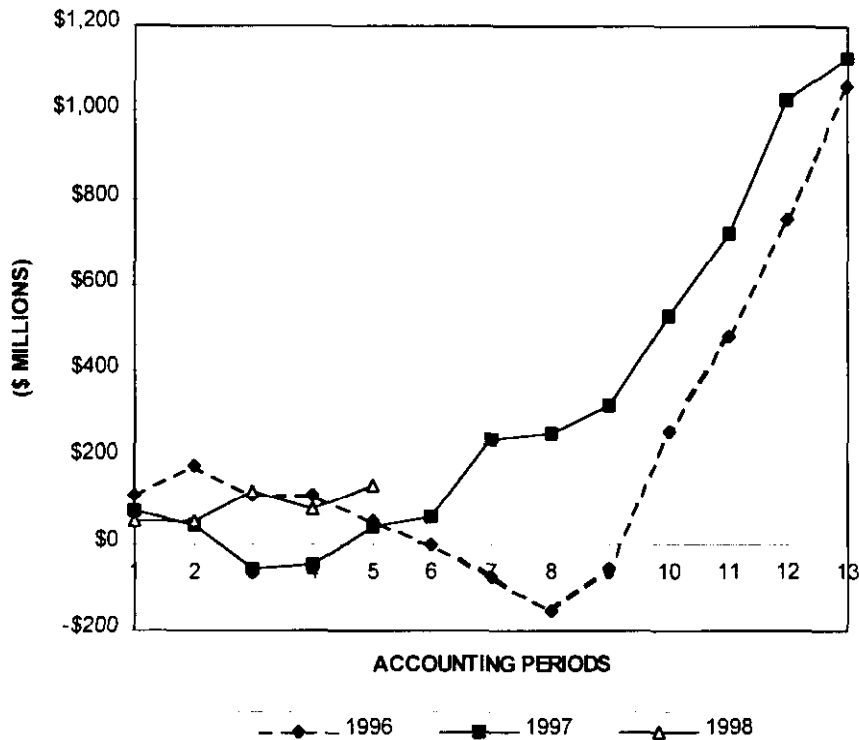
The question arises as to just how reliable are Postal Service operating plan numbers for the remaining accounting periods in FY 98? The answer is, not very. The following graph of the variance of actual earnings compared to previous budget numbers reflected in the accounting period reports demonstrates that the Postal Service numbers have not served as a good predictor of year-end profit. For the last two years the budget has been at variance with actual Postal Service earnings. In FY 96, and FY 97 and year-to-date FY 98, the Postal Service budget has significantly underestimated actual earnings. Underestimation is demonstrated in the following graph of the variance between actual versus budgeted income from the first accounting period in FY 96 through A/P 5 of FY 98.⁴⁷

⁴⁶ Rebuttal testimony of witness Porras, USPS-RT-11 at 21.

⁴⁷ Postal Service Financial Operating Statements A/P 1,1996- A/P 5,1998. See Appendix A for the data.

GRAPH 2

VARIANCE (ACTUAL VS BUDGET)
USPS FY96 AP1 - FY98 AP5 YTD INCOME/(LOSS)



The above graph demonstrates that as FY 96 and FY 97 progressed, the Postal Service operating plan increasingly underestimated actual earnings. The graph portrays the difference between actual earnings and the budget for the indicated accounting periods on a year-to-date basis. As the line on the graph moves above the horizontal axis, earnings exceed the budget by increasing amounts. The lines' large upward movement at the end of FY 96 and FY 97 indicates the Postal Service's estimates for the end of the year have been particularly pessimistic and amounted to well over \$1 billion by the end of each year. As OCA has stated previously in its response to the Commission's Notice of Inquiry No. 5, the Postal Service has provided a continuing

series of poor estimates in its exhibits:⁴⁸ "There is no doubt that with financial miscalculations of this magnitude something significant is happening with the Postal Service operations."⁴⁹ Therefore, the operating plan of the Postal Service which projects losses in the last several accounting periods of FY 98 is grossly in error.

Projecting the current earnings trend for the full test year shows the Postal Service will experience very large net profits for the 1998 test year. Given current trends, even a small loss for the year would require huge losses for the next eight accounting periods. The minimum practical increase of one cent in the First-Class rate would certainly provide excess profits, even if no other rates were increased. The Commission may instead retain the First-Class 32-cent stamp rate and increase other rates at this time in order to avoid excessive Postal Service earnings.⁵⁰ This would allow for the desired incremental rate increases for commercial mailers but avoid the transaction cost that would be incurred by First-Class mailers created by a series of small increases rather than a single two cent or three cent price jump at a later date.

⁴⁸ OCA Response to NOI No.5 at 7-9.

⁴⁹ *Id.* at 13.

⁵⁰ See Trial Brief, Major Mailers Association at 7-8, February 10, 1998.

III. CONTINGENCIES AND RPYL

As astonishing as the above graphs are in demonstrating how far off the mark the Postal Service budget and operating plan has been in absolute dollars, or how high the Postal Services earnings have been in comparison to its own pessimistic estimates, the graphs do not reflect the full picture. The above graphs do not demonstrate the even greater amount which the Postal Service says it needs to make it whole by including a contingency of \$605.6 million (recently increased to \$905.5 million as a counter to any significant Commission revenue requirement reduction).⁵¹ The previous graph also does not reflect any amount for the recovery of the \$377 million for RPYL now requested.⁵² The following graph illustrates the lopsided nature of the Postal Service request to raise its rates as compared to its recent earnings.⁵³

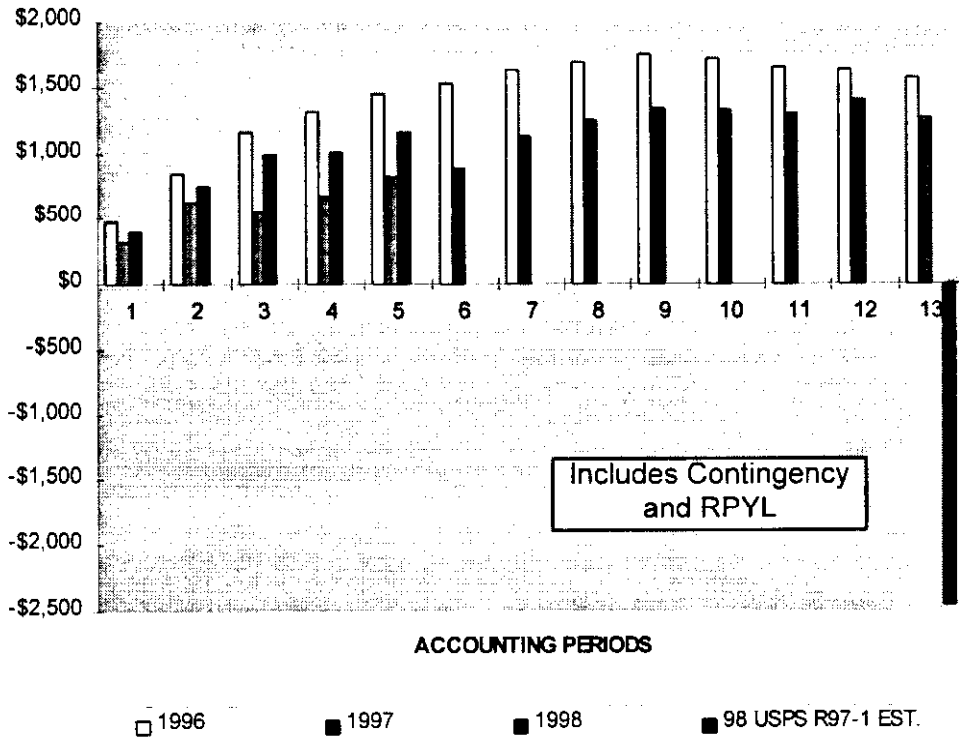
⁵¹ Rebuttal testimony of witness Porras, USPS-RT-11 at 18-19 and exhibit USPS-RT-11C.

⁵² Exhibit USPS-RT-11C.

⁵³ Postal Service Financial Operating Statements, Exhibit USPS-T9A (as revised) and USPS 1997 Annual Report. This graph includes the contingency and RPYL request. See Appendix A for the data.

GRAPH 3

USPS FY96 AP1 - FY98 AP5 YTD ACTUAL INCOME/(LOSS)
(\$ MILLIONS)



As the graph indicates, the impact of contingencies and RPYL are considerable. When added to the operating loss, the total rate shortfall is over \$2.4 billion. If the Commission finds as a fact that the Postal Service will earn a profit that is greater than the combined amount of contingency and RPYL requested, then the issue as to their proper treatment is moot as the amounts would be received in any event by the Postal Service. If, on the other hand, the Commission finds the test year earnings will be profitable but less than the combined contingency and RPYL, then the Commission needs to at least consider the proper treatment of those items. For the reasons stated below, OCA believes that no rate level increase is either required or necessary for

contingencies or RPYL if the Postal Service will otherwise earn a profit during the test year.

- A. So Much Is Known About The Test Year At The Present Time – And What Is Known Presents So Favorable A Picture Of The Postal Service’s Financial Position – That No Contingency Provision Is War-ranted At The Present Time.

Under § 3622(b) of title 39, the Commission is bound to make recommended decisions on rate requests in accordance with the policies of the Postal Reorganization Act. Among other policies, those articulated in § § 3621 must be followed:

Postal rates and fees shall provide sufficient revenues so that the total estimated income and appropriations . . . will equal as nearly as practicable total estimated costs of the Postal Service. . . . “[T]otal estimated costs” shall include [among other enumerated expenses] . . . a reasonable provision for contingencies.

The Commission delineated the breadth and limits of its authority to evaluate the contingency amount proposed by the Postal Service in PRC Op. R84-1 at paras. 1017-1047. First, the Commission stated its belief that it “could [not] ever lawfully recommend rates to the Governors based upon a revenue requirement that was not accurate, in light of the evidentiary record.” *Id.* at para. 1045. Second, the Commission rejected the assumption that “the subjective nature of [the contingency] provision puts it beyond the scope of [the] Commission’s review [or] outside Commission scrutiny.” *Id.* at para. 1046. Third, the Commission insisted that, “Nowhere does either the Act or the Second Circuit’s holding in *Newsweek* confer sole authority for determining reasonableness of the contingency upon the Board of Governors.” *Id.* Finally, the Commission stated positively its duties and powers under the Act:

Accordingly, we have concluded that the Commission has both the authority and the responsibility to make adjustments in the Postal Service's proposed revenue requirement, so long as our adjustments are not arbitrary, our reasoning is fully articulated and based upon substantial evidence in the record, and where our adjustments have neither the intent nor the effect of causing more frequent rate filings nor constitute an intrusion into the policymaking domain of the Board in accordance with the holding in *Newsweek*. *Id.* at para. 1047.

The Commission stated that the contingency provision "provides insurance against the possibility of misestimates of test year accrued revenues and expenses." *Id.* at para. 1017. The provision also is intended to "protect against unforeseeable events, not capable of being prevented through honest, efficient and economical management, and which might have a significantly adverse impact on the Service or upon its operations." *Id.* The Commission outlined several specific factors that it would consider in arriving at an appropriate contingency. These include "the Postal Service's financial condition, the state of the economy, and any other factors deemed appropriate by the Commission." *Id.* at para. 1051. Importantly, the Commission insisted that positive, as well as adverse, events must be taken into account. *Id.* at para. 1053.

In PRC OP. R87-1 at para. 2072, the Commission clarified its duty to evaluate evidence filed by the Postal Service in support of its proposed contingency: "Because the statutory requirement that a contingency be supported by substantial evidence remains in effect, management must still provide such evidence, and the Commission must still review it." In other words, as the proponent of this addition to the revenue requirement, the Postal Service must still meet its burden of proof that a particular amount for contingencies is warranted. Moreover, as part of the process of assessing the need for a particular contingency amount, the Commission explicitly (and the Postal

Service implicitly) "recognizes the predictive value of historical trends" Id. at para. 2078.

It is thus fair to conclude that the Commission does have the authority to appraise the merits of Postal Service evidence in support of its proposed contingency, that it will attempt to devise an estimate that protects against unforeseen events, but that positive unforeseen events, as well as adverse ones will be considered, and, to this end, positive historical trends will be taken into account.

Postal Service witness Tayman proposes a contingency amount of \$608.2 million in the Test Year before rates and \$605.6 million in the Test Year after rates, an amount equal to one percent of the total segment expense including final adjustments.⁵⁴ Although revised slightly on August 22, 1997, this figure essentially was proposed on July 10, 1997, approximately nine months ago, before FY 1997 had ended. A great deal of information about the Postal Service's financial condition is known now, which, naturally, could not have been taken into account when the Tayman testimony was first drafted.

First, FY 1997 ended with a much larger surplus than the Postal Service anticipated at the time its Request was filed – \$1.2644 billion instead of the projected figure of \$635.6 million.⁵⁵ Second, information is now available for the first five accounting periods of FY 1998, and it is apparent that the Postal Service's financial position is far more robust than anyone imagined in July 1997. These "unforeseen events" and "positive historical trends" must be taken into account. In doing so, the

⁵⁴ USPS-T-9 at 38 (revised).

⁵⁵ Attachment to Postal Service Response to NOI No. 5.

appropriate amount to be allotted for a contingency is significantly smaller than the \$600 million figure proposed by witness Tayman.

Calculating a contingency in Docket No. R97-1 is an exercise performed under unique circumstances. By the time the Commission issues its decision on (or before) May 9, 7/13 of Test Year 1998 will be completed, and the costs, volumes, and revenues of that period will be known. This is in stark contrast to all previous omnibus rate cases litigated since Docket No. R76-1, when the "Test Year Concept" was first addressed.⁵⁶ For example, the Commission's Opinion and Recommended Decision in Docket No. R94-1 was issued on November 30, 1994, only two months into the 1995 Test Year; the Commission's Opinion and Recommended Decision in Docket No. R90-1 was issued on January 4, 1991, three months into the 1992 Test Year; the Commission's Opinion and Recommended Decision in Docket No. R84-1 was issued on September 7, 1984, just prior to the beginning of the 1995 Test Year; the Commission's Opinion and Recommended Decision in Docket No. R80-1 was issued on February 19, 1981, prior to a hybrid test year beginning March 21, 1981;⁵⁷ and the Commission's Opinion and Recommended Decision in Docket No. R77-1 was issued on May 12, 1978, only 1½ months into a hybrid test year beginning March 25, 1978.⁵⁸

The Commission's Opinion and Recommended Decision in Docket No. R87-1, issued March 4, 1998, was issued five months into the Test Year 1989, and established precedents that are relevant to the instant case. The Commission declared that it had:

⁵⁶ PRC Op. R76-1, Vol. 2, App. B.

⁵⁷ PRC Op. R80-1 at para. 0102.

⁵⁸ PRC Op. R77-1, Vol. 2, App. B at 3.

both the authority and the responsibility to make adjustments in the Postal Service's proposed revenue requirement, so long as [the] adjustments are not arbitrary, [the] reasoning is fully articulated and based upon substantial evidence in the record, and where [the] adjustments have neither the intent nor the effect of causing more frequent rate filings nor constitute an intrusion into the policymaking domain of the Board of Governors. *Id.* at para. 2117.

Indeed, the Commission made "updates to reflect actual results;"⁵⁹ and "recommended adjustments only when actual events [had] overtaken estimates, recognition of which will result in a more representative revenue requirement estimate in the Test Year."⁶⁰

It is OCA's view that much less in TY 1998 is "unforeseen" than has ever been the case before; and the facts that are known point to continued fiscal vitality. Growth in postal revenues, it is well known, is fueled, in large measure by overall growth in the economy. All signs point to continued expansion in the economy as noted by President Clinton in a recent speech:⁶¹

Today we received more good news for our workers and our families. Our economy added another 310,000 new jobs last month. Real wages continued to rise. Unemployment fell to 4.6 percent, the lowest level in a quarter century. And more Americans are sharing in the prosperity. Hispanic unemployment, for example, fell to a record low. The American economy has now added more than 15 million new jobs since I took office. Inflation has remained low and stable. We continue to have the strongest economy in a generation, the lowest unemployment in a quarter century, the lowest inflation in 30 years, the highest homeownership in history. We're on track to have the longest peacetime recovery in the history of our country.

⁵⁹ PRC Op. R87-1 at para. 2121.

⁶⁰ *Id.* at para. 2125.

⁶¹ March 6, 1998, Remarks By The President On Unemployment Report And Job Training.

In the narrower world of postal ratemaking there is considerable good news (for example the higher YTD income in FY 1998 than SPLY), and nothing unfavorable has been presented on the record to this point. It is reasonable to expect that, as the record will soon be closed, none is likely to be presented. In particular, stability in cost segments 3, 6, and 7 is a virtual certainty since the labor contracts currently in place continue to be so throughout FY 1998; and these segments comprise approximately 50 percent of total costs.⁶²

Consequently, a smaller contingency is required. An appropriate, straightforward reduction to the \$608.2 million figure proposed by witness Tayman is to subtract 5/13 of that amount to reflect the known financial condition of the Postal Service after five accounting periods. This yields a contingency of \$374.3 million. Since the surplus estimated by OCA elsewhere in the brief is more than double that amount, no rate increases for the purpose of covering contingencies are necessary or appropriate. Furthermore, even if the Commission decides to accept Tayman's proposed \$608.2 million figure, OCA believes the FY 98 earnings will exceed that amount as well.

⁶² Using figures from the FY 1996 CRA: segment 3 costs were \$16.46 billion, segment 6 costs were \$3.95 billion, and segment 7 costs were \$7.52 billion. These sum to \$27.93 billion, while total costs were \$54.98 billion; and $\$27.93/\$54.98 = 50.8$ percent.

B. The Postal Service Has Failed To Prove That Rates Must Be Increased At The Present Time For The Purpose Of Prior Year Loss Recovery.

1. The Postal Reorganization Act does not require the recovery of prior year losses.

The Postal Reorganization Act contains no explicit requirement for the recovery of prior years' losses (RPYL). The Court in *Newsweek v. USPS*, 663 F.2d 1186 (2d Cir. 1981), indicated as much by its description of the different character of the Commission's obligations with respect to PYL and the contingency.⁶³ This is also the view consistently expressed by the Commission.⁶⁴

[The Postal Service] is treating RPYL – a component not explicitly authorized in the Postal Reorganization Act, and one originally recommended solely to accomplish a short-term restoration of the Service's initial equity – as a multi-purpose revenue supplement available to postal management to use at its own discretion, without accountability to anyone.

Indeed, a review of past Commission opinions reveals that RPYL is far from automatic. Rather, the Postal Service has to convince the Commission each time it

⁶³ Contrast the statement at 1205:

With respect to the PRC's reduction of the contingency provision Section 3621 of the Act specifically provides that the Postal Service's "total estimated costs" shall include "a reasonable provision for contingencies."

with the weaker observation, at 1204, that:

The PRC's unexplained departure from past decisions recommending the inclusion of provisions for prior years' losses was arbitrary and thus should be set aside. To the extent that the PRC claims that its decision was based on the "delinquency" of the rate request filing, that reason is simply insufficient.

⁶⁴ PRC Op. R94-1 at para. 2065. (Emphasis added). Also, PRC Op. R87-1 at para. 2025: "[PY] losses are not specifically mentioned as includable in the revenue requirement. PRC Op. R76-1 at 36-39; PRC Op. R77-1 at 44."

proposes RPYL that such an enlargement of the revenue requirement is warranted. In Docket No. R94-1, for example, the Commission repeatedly questioned the Postal Service's sincerity in actually applying RPYL for its intended purpose. ("Postal Service rebuttal witness Porras, the Postal Service's Controller, pays lip service to the goals of breaking even over time and restoring equity." PRC Op. R94-1 at para. 2064 (emphasis added); "The Postal Service's cavalier treatment of the RPYL component of the revenue requirement does not facilitate the Commission's performance of its ratemaking obligations (emphasis added)." Id. at para. 2065; "In this case, the imminent prospect of transferring over \$936 million in past operating losses to the revenue burden to be borne annually by future ratepayers . . . is sufficiently serious to challenge the breakeven rationale for the RPYL item, especially in view of postal management's history of duplicity on the application of RPYL revenues." Id. at para. 2067 (emphasis added).

2. No conditions precedent to RPYL are evident in the record of the instant proceeding.

In Docket No. R87-1, the Commission expounded on the theory of RPYL. RPYL was first included in the Docket No. R77-1 revenue requirement because "the precarious financial condition of the Postal Service warranted this novel approach to supplementing the revenue requirement." PRC Op. R87-1 at para. 2025. The Commission further explained (id.) that:

[It had] conceived of prior year loss recovery as an extraordinary measure to deal with an extraordinary problem that developed in the mid-seventies. At that time the Postal Service was posting a succession of ever-larger operating losses, and there appeared to be downward spiral of eroding equity . . . there was an extraordinary threat . . . presented by this growing succession of operating losses.

Although not specifically noted in the cited R87-1 discussion, the R77-1 opinion emphasized that the losses that were to be recovered as PYL were very recent and of short duration. PRC Op. R77-1 at 42. To summarize the Commission's views, there should be a recent history of growing negative equity and/or the expectation of an imminent further deterioration in equity. Prior discussion in the brief makes quite clear that these conditions have not been met neither for FY 96, FY 97 nor for the 1998 test year (the relevant period of analysis in this proceeding).

Furthermore, if one looks at RPYL as a distinct financial stream – separate and apart from ordinary operating expenses⁶⁵ – current rates are already contributing \$936.2 million per year toward RPYL.⁶⁶ Indeed, recovery of PYL has been unexpectedly ahead of schedule as of the end of FY 1997. The Postal Service recently adjusted downward its estimate of total PYL from \$4.0224 billion as originally proposed to \$3.3936 billion due to an unanticipated surplus of \$1.2644 billion in FY 1997 (about double the expected surplus). Attachment to the Postal Service's Response to NOI No. 5, February 13, 1998.

The Commission's Opinion and Recommended Decision in Docket No. R94-1 was issued November 30, 1994. A period of a little more than 3 years has elapsed, which should have generated RPYL of approximately \$3 billion (3 x \$936.2 million/yr). RPYL, however, is far ahead of that goal. The Commission authorized recovery of total

⁶⁵ This is clearly the approach preferred by the Commission: "The Commission . . . rejects witness Porras' assertion that prior management decisions to use RPYL revenues however it saw fit was in the best interests of either the general public or the Postal Service as an institution." PRC Op. R94-1 at para. 2065; and, "The RPYL allowance will be sufficient to this purpose only if the Postal Service formulates a coherent plan for equity restoration, and firmly commits itself to following the plan through to completion." *Id.* at para. 2069.

⁶⁶ *Id.* at para. 2071.

PYL of \$8.425 billion. PRC Op. R94-1 at para. 2049. A little more than 3 years later, RPYL yet to be recovered should have been approximately \$5.425 billion (i.e., \$8.425 billion - 3.0 = 5.425). The RPYL figure of \$3.3936 billion reported by the Postal Service in its NOI puts RPYL \$2.0314 billion ahead of the three-year target. Therefore, the need to recover PYL in the instant case is not only unnecessary, but is unjustified. Moreover, the continuing financial vigor of the Postal Service (overall, surpluses for AP1 - 5, FY 1998, are \$330 million ahead of the same period last year),⁶⁷ reinforces the position that enlarging RPYL at the present time would place an unjustified burden on postal ratepayers.

⁶⁷ Compare year-to-date (YTD) income as of AP5, FY 1998, of \$1.1553 billion to YTD income as of AP5, FY 1997, of \$825.3 million. Postal Service Financial and Operating Statements.

IV. CONCLUSION

For all the above reasons the OCA therefore believes the Commission should recommend that there be no rate increase at this time because the Postal Service has failed to carry its burden of proof that the test year costs under the existing rates will cause a test year deficit warranting an increase in rates. The Board of Governors may choose to seek reconsideration of this matter. The Commission would then have available accounting period data for all or a large portion of the remainder of the test year. Actual data will permit the Commission to verify the facts which virtually leap from the record as demonstrated in the above graphs. If the Postal Service test year does prove to be unprofitable as the Postal Service estimates, there will be sufficient opportunity for the Commission to revise its recommendations in order for the Postal Service to implement any necessary rate increase within weeks of the earliest date now anticipated by the Postal Service for their implementation.

In the alternative, if the Commission finds the Postal Service has demonstrated that a portion of the rate level increase is warranted, then the Commission should recommend no increase in First-Class rates.

Graph 1 and Graph 3 Data
YTD Income/(Loss)
(\$ Millions)

Accounting				1998
<u>Period</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>USPS R97-1 EST.</u>
1	\$ 470.8	\$ 325.7	\$ 396.2	
2	841.2	621.9	730.8	
3	1,154.8	549.4	976.1	
4	1,306.9	665.9	964.3	
5	1,445.5	825.3	1,155.3	
6	1,521.1	887.8		
7	1,635.1	1,130.2		
8	1,700.3	1,246.0		
9	1,753.9	1,338.9		
10	1,729.0	1,328.4		
11	1,652.5	1,292.4		
12	1,630.4	1,398.5		
13	1,567.0	1,264.0		\$ (2,447.0)


Graph 2 Data
YTD Variance Actual vs Budget
Income/(Loss)
(\$ Millions)

Accounting	#1	#2	#3
<u>Period</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>
1	\$ 114.8	\$ 79.4	\$ 54.0
2	182.2	44.5	55.3
3	115.5	(56.7)	124.6
4	111.9	(48.9)	83.2
5	52.4	39.7	136.0
6	0.7	61.8	
7	(73.3)	242.7	
8	(152.8)	256.7	
9	(58.8)	321.6	
10	260.0	528.2	
11	483.2	718.4	
12	752.6	1027.0	
13	1062.6	1128.2	

Sources: USPS Financial and Operating Statements, FY96 AP1 - FY98 AP5, USPS 1997 Annual Report and Exhibit USPS-T9A (as revised)

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the rules of practice.


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